MARKET SIGHT LINES

Interest Rate Worries: Higher for Longer?

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When it comes to economic activity and stock market valuations, the level and direction of interest rates matter a lot. There are forces at work today that have business leaders and investors worried we will remain in a "higher for longer" rate environment for a more extended period than has been expected recently. Inflation is firming given the Iran conflict, but the job market is resilient, so the Federal Reserve has a clear path to keep rates steady, or even hike rates if necessary. Notably, the fiscal trajectory here in the United States and elsewhere around the world is resulting in a further buildup of government debt, which has investors demanding a higher term premium on yields … another upward pressure on rates. In this Sight|Lines, we discuss recent job market and inflation data, the implications for Fed policy, and how a further buildup of government debt is playing a role, all translating to a "higher for longer" rate environment for the foreseeable future.

THE TAKEAWAY: A STRONG JOB MARKET AND FIRMING INFLATION MEAN THE FED MAY HIKE RATES

The Fed's attention has turned from rate cuts to possible rate hikes, as higher inflation from the Iran conflict comes into focus. In summary:

- Recent employment reports signal that the job market remains resilient.
- The Iran conflict has driven energy prices higher, a key input to near- and medium-term inflation.
- Wholesale prices, an input to consumer prices, have been climbing, but not yet back to 2022 levels.
- Similarly, consumer prices are heating up in recent periods.
- Given this imbalance in its dual mandate, the Fed is turning its attention from continuing its rate cut cycle to possible rate hikes.
- This represents a challenging environment as Kevin Warsh takes over as Fed Chair.
- Beyond inflation and Fed policy, deficit spending and the buildup of government debt – here in the U.S. and elsewhere – are putting even more upward pressure on interest rates.

IN-DEPTH: A STRONG JOB MARKET AND HOTTER INFLATION MEAN THE FED MAY HIKE RATES, EVEN AS A BUILDUP OF GOVERNMENT DEBT IS PUTTING UPWARD PRESSURE ON RATES AS WELL

Given higher inflation triggered by higher energy prices caused by the Iran conflict, the Fed's attention has turned from continuing rate cuts to possible rate hikes, resulting in a possible "higher for longer" rate environment. Going deeper:

- The labor market appears resilient, given the recent jobs data:
  - o The Job Openings and Labor Turnover Survey report showed U.S. job openings increased by 731,000 to 7.6 million in April, the highest since November 2024.
  - o The Nonfarm Payrolls report showed the U.S. economy added 172,000 jobs in May 2026, well above forecasts of 85,000, contributing to an unemployment rate of 4.3%.

- Energy prices have moved higher since the Iran conflict began, a key input to near- and medium-term inflation:
  - o WTI crude oil has traded more recently in the low-$90s per barrel, close to 60% higher since the start of the year.

- The Producer Price Index, a measure of wholesale inflation and an input to consumer prices, has been climbing:
  - o In May, the headline PPI was up 1.1%, and core PPI, which excludes food and energy, rose 0.4%.
  - o The year-over-year PPI rose 6.5%, and core PPI rose 5.1% – well below the March 2022 headline peak of 11.7%.

- Consumer prices are also heating up recently:
  - o In May, the headline CPI was up 0.5%, and core CPI, which excludes food and energy, rose 0.2%.
  - o The year-over-year CPI rose 4.2%, and core CPI rose 2.9% – well below the March 2022 headline peak of 8.5%.

- The Fed's dual mandate is out of balance, turning attention from more rate cuts to possible rate hikes::
  - o Before the Iran conflict, fed fund futures projected two cuts later this year, but they now signal a hike in December.

- Kevin Warsh, who has been reputed to favor rate cuts, takes over as Fed Chair starting with next week's meeting:
  - o He's known to favor monitoring core and "trimmed" inflation measures, which still point to firm inflation.
  - o Futures forecasts of a rate hike are signaling that any rate cut bias will be checked by the broader committee.

- Fiscal trajectory – deficit spending and a buildup of debt – is putting even more upward pressure on interest rates:
  - o As our Chief Economist noted, **deficits and debt do matter**, and we believe the U.S. fiscal trajectory is **not sustainable** – a risk that may keep upward pressure on longer-term rates.
  - o This translates to an upward pressure on rates as investors demand higher yields for bond investments.

WHAT WE THINK

The level and direction of interest rates are important when it comes to economic activity and stock market valuations. Business leaders and investors alike are worried we will be in a "higher for longer" rate environment for an extended period given recent market forces. The Iran conflict has driven Inflation higher. Since the job market appears resilient, the Fed's dual mandate is out of balance, which means the Fed will keep rates steady or even hike rates further. Another force driving rates higher? Deficit spending and the further buildup of government debt, which has investors demanding a higher term premium before investing. We're in a "higher for longer" rate environment for the foreseeable future, which may prove as an eventual headwind for economic activity, and a potential catalyst for equity market volatility going forward.

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